HOW MUCH CONVICTION DO YOU HAVE IN YOUR WEAK DOLLAR BETS?

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One topic on which WisdomTree has a world view that contrasts most sharply with many traditional active asset managers and some investors involves the role of currency risk in driving portfolio returns. Most investors we talk to say they do not want to make a "currency call" but then default to being unhedged in their international investments. By default, they are making the implicit call that the dollar is going to decline forever.

Stated differently, when one invests in European stocks unhedged, one has exposure to the euro plus European stocks. This euro exposure, in our view, adds unrewarded risk—in the sense that there is no risk premium that suggests the euro will *appreciate forever*, as one is relying on in unhedged equity strategies.

Is it expensive to hedge? Certainly not for the developed world. As the Federal Reserve (Fed) has been hiking rates, investors are now paid 2% plus implied interest rate differentials in forward contracts to hedge the euro and the yen—this interest rate income is not collected in unhedged strategies.

What Is Truly Currency Neutral?

WisdomTree has been advocating since 2009 that a truly currency-neutral policy would be to fully hedge one's currency risk, and then one should add in that risk when one has a favorable view on that currency or basket of currencies. Most people do not have conviction in these currency calls, which is why WisdomTree believes more people should be hedged as a default.

One other default setting for investors is to let their active managers make currency decisions for them. Now, here is where active managers often will say we are "stock pickers," not currency experts, yet their default setting also is to bet long on the euro.

Having a Plan and Sticking to It

My friends Ben Carlson and Michael Batnick on their "Animal Spirits" podcast have touched on this currency topic a few times; their view often comes down to there being "no right answer" and that the most important thing for investors is to have a plan and stick to it. If one tries to time the currency call, many will have a great chance of rotating between hedged and unhedged strategies at the wrong time. I agree with that sentiment if one does not have a world view on how best to manage this risk.

However, just as there are well-documented equity factors that have ample evidence to suggest one can earn different "factor" risk premiums, WisdomTree believes there are similar factors at play in the currency markets that overlap with the equity factors.

Two of the factors are often discussed: value and momentum. These are two factors on opposing sides; value stocks or value currencies would tend to be ones that have been depreciating, while momentum is following price trends higher. In currencies, we evaluate value with an intrinsic fair value measure of purchasing power parity (PPP). PPP tries to equate baskets of goods in different currencies, also relying on the fact that currencies can become far overvalued and undervalued and will not tend to stay close to that fair value.

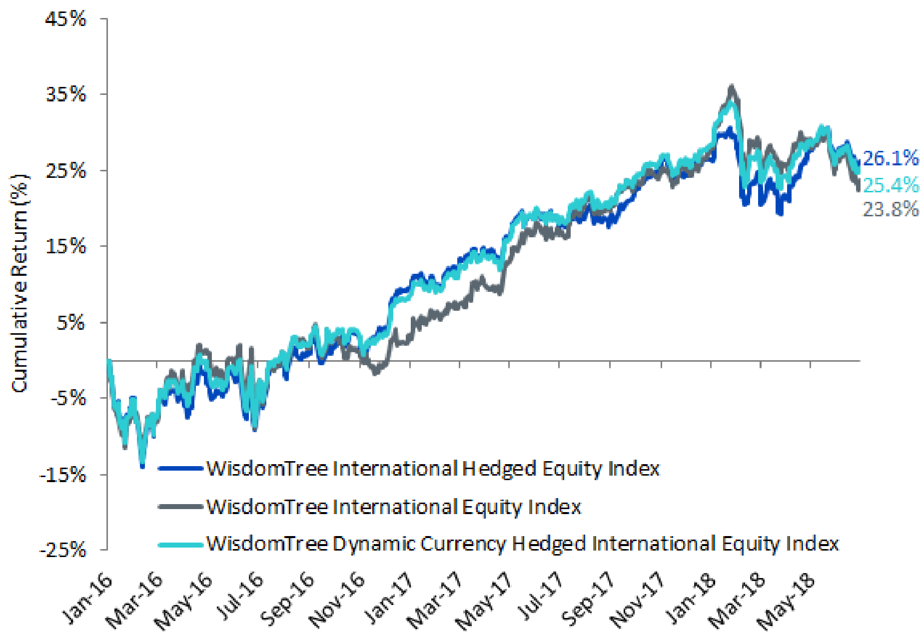
The third factor for currencies is interest rates, or "carry." This factor helps manage the cost of hedging by only hedging developed-world currencies when one is paid to do so and being unhedged when it costs carry. This signal calls for hedging broadly today given the divergent global central bank policies: the Fed is hiking rates, and many foreign central banks are still in negative interest rate territory.

We now have two and a half years of real-time performance of WisdomTree's dynamically hedged currency suite of strategies that incorporate a rules-based approach to add hedges on this three-factor currency model. During this time period, we've had some dramatic currency cycles.

- 2016 was a very strong dollar environment, and one can see the WisdomTree dynamically hedged Index keeping up with the fully hedged WisdomTree Index during 2016.
- 2017 was a weak dollar period in which the dollar declined 8.5%[1] and unhedged strategies got a currency kicker through the first quarter of 2018.
- In the second quarter of 2018, the dollar appreciated 5.5%,[2] sending hedged indexes ahead of unhedged indexes over the full two-and-a-half-year period that WisdomTree's dynamically hedged Index has been live.

Since 2016: WisdomTree Dynamic Currency Hedged Compared to Unhedged and Fully Hedged

WT International Indexes



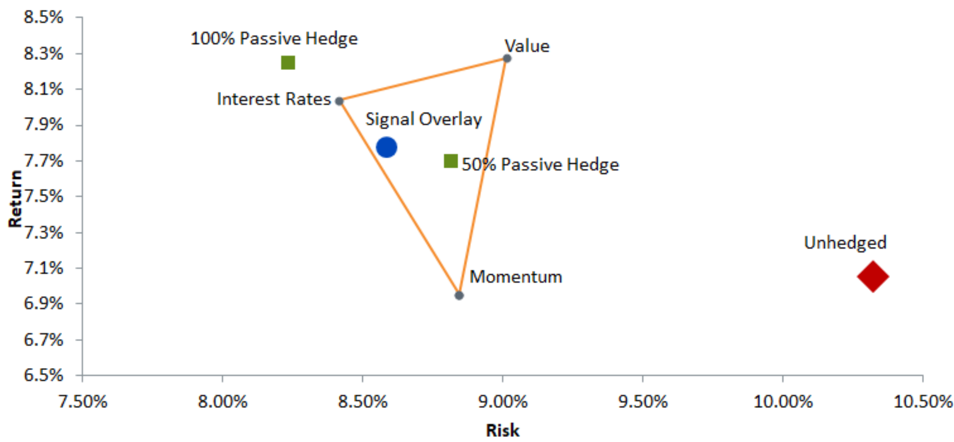
Calendar Year Performance			
Index	**2016**	**2017**	**2018 YTD**
WT Dynamic Currency Hedged Int'l Equity	8.3%	18.5%	-2.3%
WT International Equity	3.2%	23.9%	-3.2%
WT International Hedged Equity	9.4%	15.5%	-0.2%

Sources: WisdomTree, Bloomberg, for the period 1/1/2016–6/30/2018. Past performance is not indicative of future results. You cannot invest directly in an index.

From a risk attribution perspective, one of the dynamics that is clear: the strategy that has the most risk is WisdomTree's unhedged Index. A 50% passive hedge is the best benchmark for this dynamically hedged Index because it will rotate around 50% hedge ratios, and in real time the hedge has been between 40% to 80%.

WisdomTree International Equity Index under Different Currency-Hedging Approaches

WisdomTree®



Source: WisdomTree, Record Currency Management, for the period 11/2/15–6/30/18. Chart data points are labeled to reflect which hedge approach is being applied to the WisdomTree International Equity Index. Past performance is not indicative of future results. All data points refer to variations on currency risk of the WisdomTree International Equity Index. 100% Passive Hedge refers to the performance with 100% of the currency risk hedged. Unhedged refers to the index with no currency hedge. 50% passive hedge refers to the performance with 50% of the currency risk hedged. Signal Overlay refers to the performance of with the Dynamic Currency Hedge. Momentum, Value, and Value refer to the performance attributable to the three components of the Signal Overlay or Dynamic Currency Hedge.

Dynamic Signal Overlay: Three-Factor Model

The signal overlay in the risk attribution box combines the value signal, momentum signal, and carry signal into this three-factor currency model.

Of the single-factor signals, interest rates over this period had the greatest risk reduction because they suggested the highest hedge ratios. This is because of how much the Fed has been hiking rates. In 2017, this signal did not work as the dollar declined, but still the risk reduction is evident. Value from a return perspective has been a value-added signal over the last two and a half years because it helped reduce hedge ratios on the euro before its rally in 2017. The momentum signal has helped reduce risk over the last two and a half years, but it has been the weakest of signals from a return perspective.

Over long-enough currency cycles, which we think of as five to seven years, we believe the signal overlay can outperform hedged, unhedged and 50% hedged benchmarks. Over the last two and a half years, we see that the dynamic signal overlay has now outperformed unhedged and 50% hedged benchmarks, while reducing risk of unhedged indexes by 174 basis points per year.

Overseas equities are often perceived as “riskier” than U.S. equities—but one of the factors that makes them riskier is currency, as we discussed here. Whether one employs a fully hedged, a 50% passive hedge or a dynamic hedge to add value over a 50/50 benchmark, this risk chart helps showcase the one strategy WisdomTree would suggest avoiding over the long run: being unhedged all the time.

[1]Source: Bloomberg, for the period 12/30/16–12/29/17, based on the Bloomberg Dollar Spot Index.

[2]Source: Bloomberg, for the period 3/29/18–6/29/18, based on the Bloomberg Dollar Spot Index.

Important Risks Related to this Article

Hedging can help returns when a foreign currency depreciates against the U.S. dollar but can hurt when the foreign currency appreciates against the U.S. dollar.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Implied interest rate : The annualized interest rate implied by forward currency contracts relative to spot rates.

Forward contracts : Agreements to buy or sell a specific currency at a future date at an agreed upon rate.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.